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Sandpiper Capital

Gleanings

500 E. Plume St #109
Norfolk, VA 23510
(757) 512-6933

www.sandpiper-capital.com

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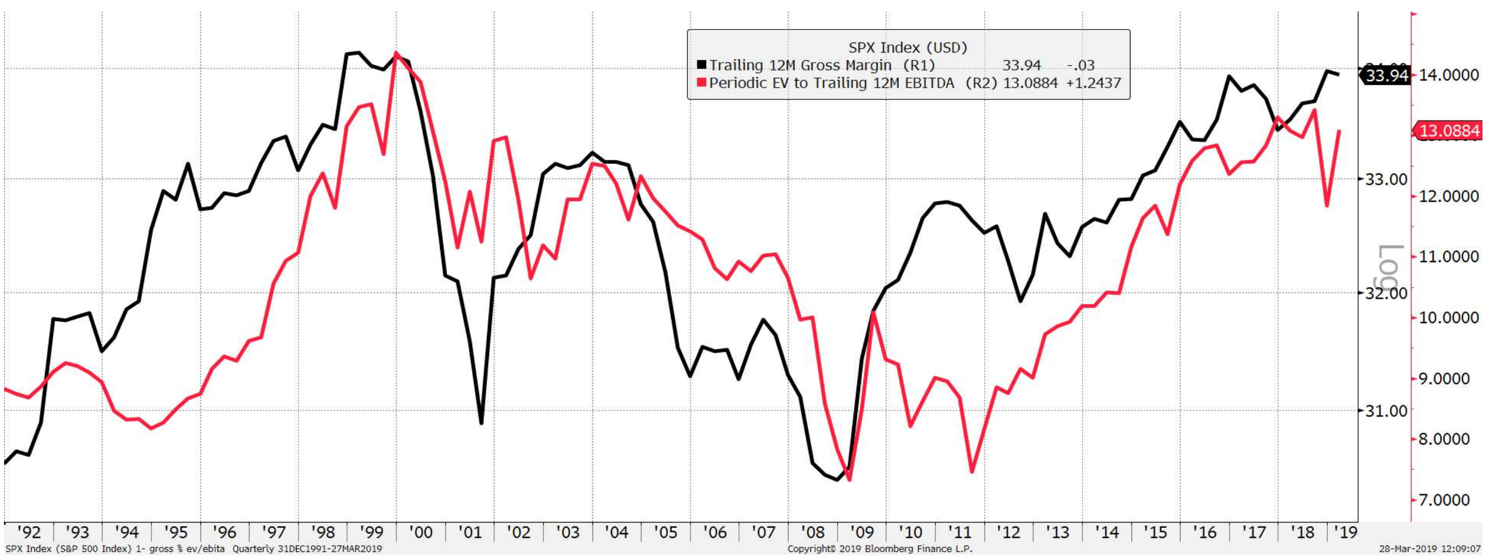
Market Returns Annually

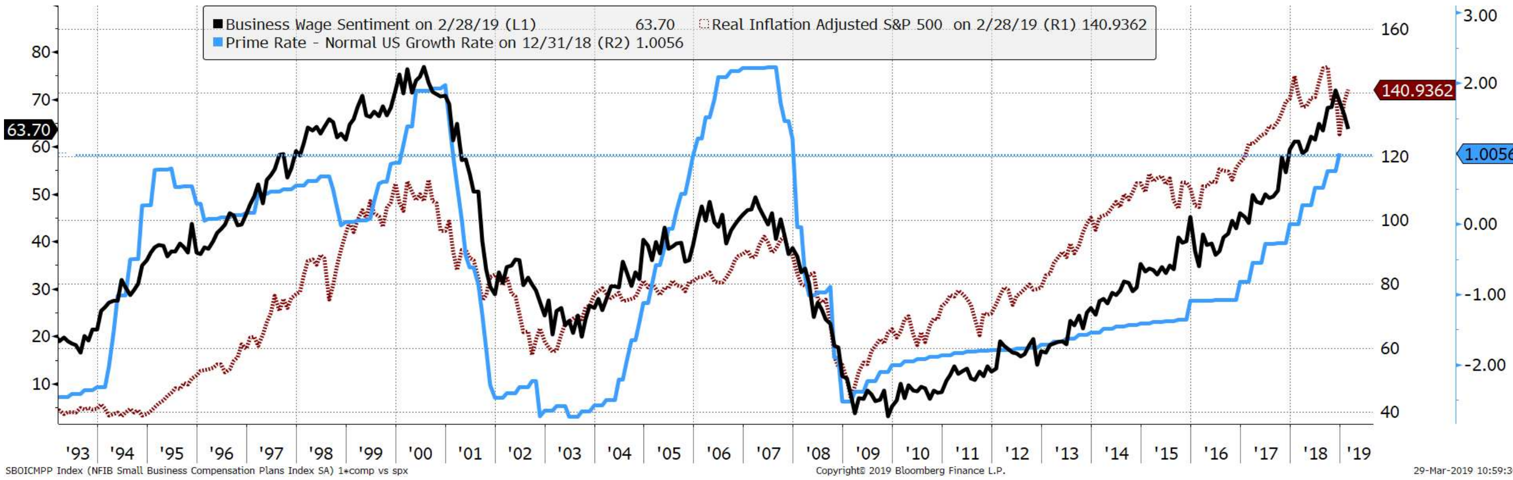
Index	2016	2017	2018	YTD
S&P 500	11.9	21.8	-4.4	**13.7%**
ML 1-5 yr Gov't/Corp	1.6	.4	1.2	**1.6%**
EAFE (Dev Fgn Mkts)	1.0	25.1	-13.8	**10%**
Emerging Markets	11.8	37.9	-14.5	**9.9%**

New rules

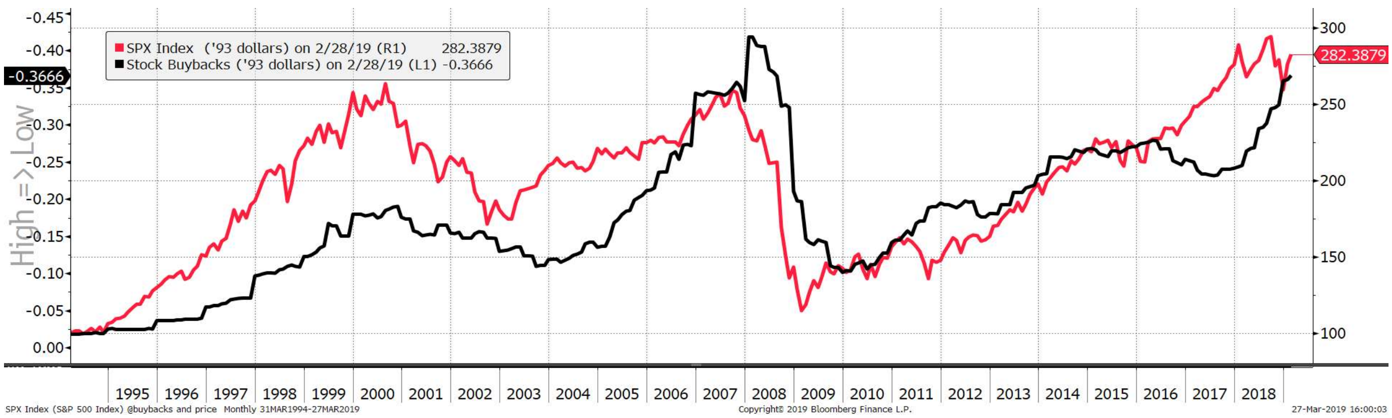
The market certainly bounced back pretty crisply from December lows as it became clear that interest rates were done rising. While economic news (including a sharp drop in new payrolls last month) indicates that we may have seen a peak in the economy's growth last quarter, it's still not obvious that means that we start back down anytime soon. Typically, at this stage of the market cycle, you still see some optimism based upon the generous levels of profitability that are associated with an economy that's running at (or closer to) full steam. In the chart below there is a seventeen year history of the S&P's profitability (in black) graphed against the value that investors are willing to pay for its shares (in red). When profits are at their highest, as in 1999-2000, you get a lot more willingness to project those good times out into the extended future and you can see that in the rich valuations, (14 x's cash flow compared to the average of 11.5 x's). So, while the S&P is pretty rich today, those valuations can be justified by the margins that S&P companies are enjoying, at least until that situation changes.



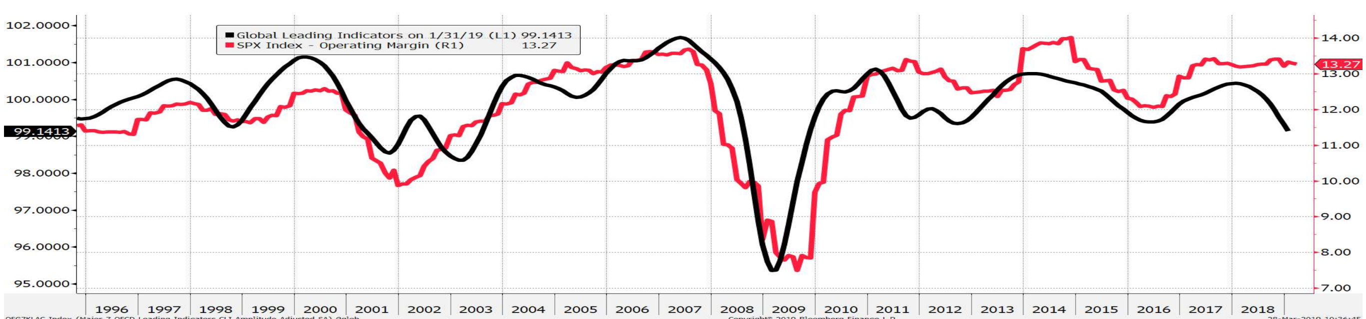
What might cause margins to fall as they did in 2000 and 2005? In both of those cases, higher interest rates generated by a Federal Reserve intent upon controlling rising wages eventually slowed the economy and created recessions. In the chart at the top of the reverse, you'll see that the blue line, representing the cost of borrowing at the prime rate is back up to the restrictive zone that it hit in 2000 and early 2006. It looks as if that has already shifted wage sentiment, as reflected by the survey results indicated by the black line. That we have strong indications that there is no intention to raise rates any further might mean that we can hover at current levels for a while as we did in 2006 and 2007. It really depends upon whether or not the dampened consumption that has resulted from the higher cost of borrowing causes companies to start reducing expenses by trimming their workforce through new rounds of layoffs and offshoring. There is, as of yet, no clear signal that's happening, but the wage surveys referenced here tend to lead those efforts by a few months.



Keeping valuations inflated, for now, we also have the substantial tax cut inspired stock buybacks. Obviously, when things get tight, those stop and that extra push to stock prices disappears



and it doesn't help that the rest of the world's economies are experiencing slowing growth. It's very hard to increase prices when people are tightening their belts. It's even harder when foreign competitors are cutting prices to increase their exports. The evidence of that can be found in the 2019 earnings estimates coming out of Wall Street with more companies seeing estimates reduced than increased. So, all in all, current good times may be short-lived.



Tom Lukic